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No. 544

In the Supreme Court of the United States

October Term, 1963

[redacted]

v.

[redacted]

ON [redacted]

BRIEF FOR THE UNITED STATES IN OPPOSITION

[redacted]
Solicitor General,
[redacted]
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In the Supreme Court of the United States

OCTOBER TERM, 1963

No. 345

MANUFACTURERS HANOVER TRUST COMPANY, AS TRUSTEE UNDER INDENTURE DATED NOVEMBER 5, 1927, MADE BY HENRY H. ROGERS, DECEASED, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINION BELOW

The opinion of the Court of Claims (Pet. 17–38) is reported at 312 F. 2d 785.

JURISDICTION

The judgment of the Court of Claims was entered on August 5, 1963. The petition for a writ of certiorari was filed on August 7, 1963. The jurisdiction of this Court is invoked under 28 U.S.C. 1255(1).

QUESTIONS PRESENTED

1. Whether attorneys' fees incurred by a trust in defending the trustee's continued title to trust property are deductible under Section 212(2) of the Internal Revenue Code of 1954 as ordinary and necessary expenses for the management, conservation, or maintenance of property held for the production of income; or are nondeductible as capital expenditures.

2. Whether, in allocating trust management expenses between tax-exempt and other income in order to determine the amount of such expenses which is non-deductible pursuant to Section 265(1) of the Internal Revenue Code of 1954, the Court of Claims erred in holding that only those items of trust income which are distributable to the income beneficiaries are to be taken into consideration rather than the total trust income.

STATUTE AND REGULATIONS INVOLVED

The pertinent portions of the Internal Revenue Code of 1954, Sections 212, 263(a)(1), 265(1), 643(a), and 652 (a) and (b), and of Treasury Regulations on Income Tax (1954 Code), Sections 1.212-1 (i) and (k), 1.263(a)-2(e); 1.265-1(e), 1.652(b)-3(b), and 1.652 (c)-4, are set forth in the Appendix, *infra*, pp. 12–20.

STATEMENT

The facts as found by the Court of Claims (Pet. 17–20) may be summarized as follows:

On November 5, 1927, Henry H. Rogers created a trust in contemplation of the forthcoming marriage of his daughter Millicent to Arturo Peralta Ramos.

The trust indenture provided that the net income of the trust was payable to Millicent for her life, and at her death the trust was to be divided into equal shares, one share to be held in trust for, and the net income therefrom payable for life to, each surviving child of the marriage. Thereafter, the corpus of each share of the trust was to be paid to that child's issue *per stirpes;* or, in default of issue, to his brothers or sisters or their issue; and in case of default of such beneficiaries, to the grantor or those entitled to take under his will. The indenture also contained reservations of reversionary interests in the event Millicent was survived by only one child, or by no children, but these provisions never came into effect, for at her death on January 1, 1953, she was survived by Arturo Henry Peralta Ramos and Paul Jaime Peralta Ramos, the two sons of her marriage to Ramos. Prior to her death, Millicent's marriage to Ramos was terminated by divorce. (Pet. 18.)

Henry H. Rogers died testate on July 25, 1935, leaving a part of his residuary estate in trust for his widow, Pauline, who remarried and became Pauline V. Hoving. (Pet. 18–19.)

Subsequent to the death of Millicent early in 1953 there was uncertainty as to the validity of the continuing trusts in favor of Arturo Henry and Paul under Section 11 of the New York Personal Property Law, which prohibits suspension of the absolute power of alienation for more than two lives in being. On January 7, 1954, the trustee (petitioner herein) filed a petition in the Supreme Court of the State of New

York for an order settling its account as trustee and fixing and allowing its commissions, and asked the court to construe the trust indenture and the grantor's will and instruct the trustee as to the disposition of the trust assets. Millicent's executors, her two sons Arturo Henry and Paul Ramos, the infant son of Arturo Henry, another son of Millicent by a later marriage, and Mrs. Hoving were among those made parties to the proceeding, and they, as well as the trustee, participated and prepared briefs on the issue of the validity of the trust. The position of Mrs. Hoving, residuary legatee of Henry H. Rogers, was that under New York law the continuing trusts for Arturo Henry and Paul were illegal and void, and she apparently also attacked the entire *inter vivos* trust indenture of November 5, 1927. The other participants, opposing the interpretation advanced by Mrs. Hoving, contended that the trust indenture was wholly valid. (Pet. 19.)

On November 29, 1954, after extended negotiations, the parties settled the proceeding by stipulation. Under the terms of the stipulated agreement, Mrs. Hoving consented that an order be entered construing the secondary trusts as valid and assigned whatever right she had to the trust assets to Arturo Henry and Paul in consideration of $40,000 paid by them from their own funds. The parties also stipulated, subject to court approval, the various allowances to be paid to the several attorneys (and to the guardian *ad litem* of the infant respondent), and further agreed that all

such allowances should be paid by the trust. The court entered a final order on December 6, 1954, to the effect that the trustee's accounts were approved and settled; that the continuing trusts were valid and enforceable; and that the trustee was to pay out of the trust corpus $49,000 in attorneys' fees and $15.25 for incidental disbursements. (Pet. 19-20.)

In its fiduciary income tax return for 1954 the trustee claimed a deduction of the entire $49,015.25 paid out in the trust litigation. After an audit, the Commissioner of Internal Revenue disallowed the deduction "to the extent of $35,315.25 for the reason that to that extent the expenditures were not deductible under section 212 of the Internal Revenue Code of 1954 but should be capitalized under section 263 as an expenditure to perfect title." The $13,700 allowed by the Commissioner was attributed by him to the accounting aspect of the litigation and therefore allowable as an ordinary and necessary expense of the trust. The trustee paid the deficiency and then filed a claim for refund. The Commissioner rejected the refund claim (Pet. 20) and the present suit followed.

In ruling on cross-motions for summary judgment (Pet. 17), the Court of Claims approved the Commissioner's disallowance of the deduction and dismissed the petitioner-trustee's petition insofar as it sought a reversal of the Commissioner's determination that only the sum of $13,700 was properly deductible (Pet. 38).

ARGUMENT

1. The Court of Claims correctly applied the law to the particular facts of this case. There is no conflict of decisions or other cause for review.

The attorneys' fees sought to be deducted by the trustee were incurred by the trust in a suit involving a challenge to the trustee's title to trust property. Mrs. Hoving, the residuary beneficiary under the will of Henry H. Rogers, was claiming that the trust property belonged to her on the ground that the trust, and in particular the continuing trusts for the benefit of Arturo Henry Peralta Ramos and Paul Jaime Peralta Ramos, were illegal and void under State law. Indeed, before these subsidiary trusts could continue it was necessary for the subsidiary beneficiaries to pay Mrs. Hoving a considerable sum of money (out of their own funds), whereupon she withdrew her opposition and gave her consent to the continued possession of the trust property by the trustee. The record, therefore, amply supports the holding of the Court of Claims (Pet. 25) that the "essence" of this litigation was the "perfection and defense of the trustee's claimed title to the trust property."

It follows that the expenses involved here are not deductible. True, Section 212(2) of the Internal Revenue Code of 1954 (Appendix, *infra*, p. 12) allows a deduction for all ordinary and necessary expenses paid or incurred during a particular taxable period "for the management, conservation, or maintenance

of property held for the production of income" and such expenses include reasonable amounts paid or incurred by the fiduciary of an estate or trust "on account of administration expenses, including fiduciaries' fees and expenses of litigation, which are ordinary and necessary in connection with the performance of the duties of administration" (Treasury Regulations on Income Tax (1954 Code), Section 1.212–1(i), Appendix, *infra*, p. 16). But, contrary to petitioner's argument, the provision invoked does not apply to all litigation expenses incurred by fiduciaries. Under Sections 1.212–1(k) and 1.263 (a)–2 of the pertinent Regulations (Appendix, *infra*, pp. 16–17), expenses paid or incurred in "defending or perfecting title to property" are not deductible but, instead, must be capitalized together with the cost of such property. Thus, where the fundamental purpose of the litigation is to determine title (*Lewis* v. *Commissioner*, 253 F. 2d 821, 827–828 (C.A. 2); *Loyd* v. *United States*, 153 F. Supp. 416, 419 (Ct. Cl.)) attorneys' fees and the like are not currently deductible, whether expended by individuals (see *Bowers* v. *Lumpkin*, 140 F. 2d 927, 928–929 (C.A. 4), certiorari denied, 322 U.S. 755) or by fiduciaries (*Brown* v. *Commissioner*, 215 F. 2d 697, 699–700 (C.A. 5); *Parkway Realty Corp.* v. *Commissioner*, decided March 16, 1959 (P–H Memo T.C., par. 59,050)).

Petitioner is incorrect in asserting (Pet. 7–8) that the decision below is in conflict with *Trust of Bingham* v. *Commissioner*, 325 U.S. 365. In that case this Court was dealing with expenditures for legal advice in connection with the payment of legacies and with tax and other problems arising upon the expiration of the trust. Such expenditures, the Court held, were deductible as expenses incurred for the production of income because a distribution of the trust corpus at the termination of the estate is part and parcel of the management of trust property. No question was there presented as to the deductibility of expenses incurred for the perfection or defense of title.[1]

2. There is plainly no occasion for review in this Court of the allocation made of the "indirect expenses" (Pet. 28) which are deductible only to the extent that they are not allocable to a class of income wholly exempt from tax. See 1954 Code, Section 265(1), Appendix, *infra*, pp. 12–13. Concededly, some

[1] *Trust of Spero* v. *Commissioner*, 30 T.C. 845, dismissed February 6, 1959 (C.A. 6), cited by petitioner (Pet. 8), is also factually distinguishable from the present case. There, where a trustee sought to capitalize certain litigation expenses on the ground that they were incurred in defending or perfecting title to property, the Tax Court viewed the expenses as having been incurred in connection with resolving conflicting claims of several beneficiaries. In this connection it is noteworthy that a more recent Tax Court case, *Parkfray Realty Corp.* v. *Commissioner*, *supra*, is almost factually identical to the present case and that the Tax Court's decision in that case is in accord with the decision below.

portion of these expenses is allocable to income of $8,370.85 in tax-exempt interest.. Though it recognized that the issue seems to be moot in the present case (Pet. 33–34), the court nevertheless went on to hold that the allocation should be made by applying the ratio which the tax-exempt interest bears to the "distributable net income" of the trust, thereby excluding from the allocation base capital gains and taxable stock dividends which are allocable to the trust principal under local law and the trust indenture.[2] The court's holding is in accord with *Tucker* v. *Commissioner*, 38 T.C. 955, affirmed August 7, 1963 (C.A. 2), the only other case involving this allocation issue.

The ruling reflects the special taxing system established in that portion of the 1954 Code dealing with the income taxation of estates, trusts, beneficiaries and decedents and is supported by administrative interpretation embodied in the pertinent Treasury Regulations (Section 1.652(c)–4(c), Appendix, *infra*, p. 20) and in Instruction 39 to Form 1041. As the court below explained (Pet. 28–31), the 1954 Code provided for a "flow through" scheme of taxation as to "distributable net income" under which a deduction is allowed the trust for the income which is currently dis-

[2] During the taxable year the trust reported the following amounts and classes of income (Pet. 28, fn. 8):

Dividends (domestic and foreign) allocable to income	$26,395.95
Interest allocable to income	468.75
Dividends allocable to principal	162.25
Long-term capital gains allocable to principal	71,205.24
Tax-exempt interest	8,370.85

tributable to beneficiaries and such income is included in the gross income of the beneficiaries. Section 643 (a) of the 1954 Code (Appendix, *infra*, pp. 13–14) defines "distributable net income" as excluding capital gains and stock dividends not paid or credited to any beneficiary because allocable to principal. See also Section 652(b), Appendix, *infra*, p. 15. Since the trust receives a deduction for currently distributable income, the "distributable net income" (computed without capital gains and stock dividends chargeable to principal) is, as the court below stated (Pet. 30–31), the measuring rod or yardstick for determining both the maximum deduction for distribution allowed the trust and the extent to which beneficiaries are taxable on the distributions. It logically follows, as the Regulations and Instruction 39 to Form 1041 reflect, that the allocation of expenses required by Section 265(1) of the 1954 Code must operate with reference to income which excludes capital gains and stock dividends chargeable to principal.

Petitioner complains that the result sanctions an unreasonable and arbitrary exercise by the Commissioner of his rulemaking power (Pet. 9); but, as the court below explained (Pet. 36), there is no unfairness. In sum, a decrease in the amount of expenses deductible by allocation is offset by an increase in the amount of the trust's deduction for distributable income, with the tax benefit of deductions allocable to corpus being generally shifted to the income beneficiaries.

CONCLUSION

For the reasons stated, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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SEPTEMBER 1963.

APPENDIX

Internal Revenue Code of 1954:

SEC. 212. EXPENSES FOR PRODUCTION OF INCOME.

In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—

(1) for the production or collection of income;

(2) for the management, conservation, or maintenance of property held for the production of income; or

(3) in connection with the determination, collection, or refund of any tax.

SEC. 263. CAPITAL EXPENDITURES.

(a) *General Rule.*—No deduction shall be allowed for—

(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.

* * * * * * *

SEC. 265. EXPENSES AND INTEREST RELATING TO TAX-EXEMPT INCOME.

No deduction shall be allowed for—

(1) *Expenses.*—Any amount otherwise allowable as a deduction which is allocable to one or more classes of income other than interest (whether or not any amount of income of that class or classes is received or accrued) wholly exempt from the taxes imposed by this subtitle, or any amount otherwise allowable under section 212 (relating to expenses for production of

income) which is allocable to interest (whether or not any amount of such interest is received or accrued) wholly exempt from the taxes imposed by this subtitle.

* * * * *

SEC. 643. DEFINITIONS APPLICABLE TO SUBPARTS A, B, C, AND D.

(a) *Distributable Net Income.*—For purposes of this part, the term "distributable net income" means, with respect to any taxable year, the taxable income of the estate or trust computed with the following modifications—

(1) *Deduction for distributions.*—No deduction shall be taken under sections 651 and 661 (relating to additional deductions).

(2) *Deduction for personal exemptions.*—No deduction shall be taken under section 642(b) (relating to deduction for personal exemptions).

(3) *Capital gains and losses.*—Gains from the sale or exchange of capital assets shall be excluded to the extent that such gains are allocated to corpus and are not (A) paid, credited, or required to be distributed to any beneficiary during the taxable year, or (B) paid, permanently set aside, or to be used for the purposes specified in section 642(c). Losses from the sale or exchange of capital assets shall be excluded, except to the extent such losses are taken into account in determining the amount of gains from the sale or exchange of capital assets which are paid, credited, or required to be distributed to any beneficiary during the taxable year. The deduction under section 1202 (relating to deduction for excess of capital gains over capital losses) shall not be taken into account.

(4) *Extraordinary dividends and taxable stock dividends.*—For purposes only of subpart B (relating to trusts which distribute current income only), there shall be excluded those [illegible]

of gross income constituting extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, does not pay or credit to any beneficiary by reason of his determination that such dividends are allocable to corpus under the terms of the governing instrument and applicable local law.

(5) *Tax-exempt interest.*—There shall be included any tax-exempt interest to which section 103 applies, reduced by any amounts which would be deductible in respect of disbursements allocable to such interest but for the provisions of section 265 (relating to disallowance of certain deductions).

(6) *Foreign income.*—In the case of a foreign trust, there shall be included the amounts of gross income from sources without the United States, reduced by any amounts which would be deductible in respect of disbursements allocable to such interest but for provisions of section 265(1) (relating to disallowance of certain deductions).

(7) *Dividends.*—There shall be included the amount of any dividends excluded from gross income pursuant to section 116 (relating to partial exclusion of dividends received).

If the estate or trust is allowed a deduction under section 642(c), the amount of the modifications specified in paragraphs (5) and (6) shall be reduced to the extent that the amount of income which is paid, permanently set aside, or to be used for the purposes specified in section 642(c) is deemed to consist of items specified in those paragraphs. For this purpose, such amount shall (in the absence of specific provisions in the governing instrument) be deemed to consist of the same proportion of each class of items of income of the estate or trust as the total of each class bears to the total of all classes.

SEC. 652. INCLUSION OF AMOUNTS IN GROSS INCOME OF BENEFICIARIES OF TRUSTS DISTRIBUTING CURRENT INCOME ONLY.

(a) *Inclusion.*—Subject to subsection (b), the amount of income for the taxable year required to be distributed currently by a trust described in section 651 shall be included in the gross income of the beneficiaries to whom the income is required to be distributed, whether distributed or not. If such amount exceeds the distributable net income, there shall be included in the gross income of each beneficiary an amount which bears the same ratio to distributable net income as the amount of income required to be distributed to such beneficiary bears to the amount of income required to be distributed to all beneficiaries.

(b) *Character of Amounts.*—The amounts specified in subsection (a) shall have the same character in the hands of the beneficiary as in the hands of the trust. For this purpose, the amounts shall be treated as consisting of the same proportion of each class of items entering into the computation of distributable net income of the trust as the total of each class bears to the total distributable net income of the trust, unless the terms of the trust specifically allocate different classes of income to different beneficiaries. In the application of the preceding sentence, the items of deduction entering into the computation of distributable net income shall be allocated among the items of distributable net income in accordance with regulations prescribed by the Secretary or his delegate.

* * * * *

Treasury Regulations on Income Tax (1954 Code):

§ 1.212-1 *Nontrade or nonbusiness expenses.*

* * * * *

(i) Reasonable amounts paid or incurred by the fiduciary of an estate or trust on account of administration expenses, including fiduciaries' fees and expenses of litigation, which are ordinary and necessary in connection with the performance of the duties of administration are deductible under section 212, notwithstanding that the estate or trust is not engaged in a trade or business, except to the extent that such expenses are allocable to the production or collection of tax-exempt income. But see section 642 (g) and the regulations thereunder for disallowance of such deductions to an estate where such items are allowed as a deduction under section 2053 or 2054 in computing the net estate subject to the estate tax.

* * * * *

(k) Expenses paid or incurred in defending or perfecting title to property, in recovering property (other than investment property and amounts of income which, if and when recovered, must be included in gross income), or in developing or improving property, constitute a part of the cost of the property and are not deductible expenses. Attorneys' fees paid in a suit to quiet title to lands are not deductible; but if the suit is also to collect accrued rents thereon, that portion of such fees is deductible which is properly allocable to the services rendered in collecting such rents. Expenses paid or incurred in protecting or asserting one's right to property of a decedent as heir or legatee, or as beneficiary under a testamentary trust, are not deductible.

* * * * *

§ 1.263(a)–2 *Examples of capital expenditures.*

The following paragraphs of this section include examples of capital expenditures:

* * * * *

(c) The cost of defending or perfecting title to property.

* * * * * *

§ 1.265–1 *Expenses relating to tax-exempt income.*

* * * * * *

(c) *Allocation of expenses to a class or classes of exempt income.* Expenses and amounts otherwise allowable which are directly allocable to any class or classes of exempt income shall be allocated thereto; and expenses and amounts directly allocable to any class or classes of nonexempt income shall be allocated thereto. If an expense or amount otherwise allowable is indirectly allocable to both a class of nonexempt income and a class of exempt income, a reasonable proportion thereof determined in the light of all the facts and circumstances in each case shall be allocated to each.

* * * * * *

§ 1.652(b)–3 *Allocation of deductions.*

Items of deduction of a trust that enter into the computation of distributable net income are to be allocated among the items of income in accordance with the following principles:

* * * * * *

(b) The deductions which are not directly attributable to a specific class of income may be allocated to any item of income (including capital gains) included in computing distributable net income, but a portion must be allocated to nontaxable income (except dividends excluded under section 116) pursuant to section 265 and the regulations thereunder. For example, if the income of a trust is $30,000 (after direct expenses), consisting equally of $10,000 of dividends, tax-exempt interest, and rents, and income commissions amount to

$3,000, one-third ($1,000) of such commissions should be allocated to tax-exempt interest, but the balance of $2,000 may be allocated to the rents or dividends in such proportions as the trustee may elect. The fact that the governing instrument or applicable local law treats certain items of deduction as attributable to corpus or to income not included in distributable net income does not affect allocation under this paragraph. For instance, if in the example set forth in this paragraph the trust also had capital gains which are allocable to corpus under the terms of the trust instrument, no part of the deductions would be allocable thereto since the capital gains are excluded from the computation of distributable net income under section 643(a)(3).

* * * * *

§ 1.652(c)–4 *Illustration of the provisions of sections 651 and 652.*

The rules applicable to a trust required to distribute all of its income currently to its beneficiaries may be illustrated by the following example:

Example. (a) Under the terms of a simple trust all of the income is to be distributed equally to beneficiaries A and B and capital gains are to be allocated to corpus. The trust and both beneficiaries file returns on the calendar year basis. No provision is made in the governing instrument with respect to depreciation. During the taxable year 1955, the trust had the following items of income and expense:

Rents	$25,000
Dividends of domestic corporations	50,000
Tax-exempt interest on municipal bonds	25,000
Long-term capital gains	15,000
Taxes and expenses directly attributable to rents	5,000
Trustee's commissions allocable to income account	2,600
Trustee's commissions allocable to principal account	1,300
Depreciation	5,000

(b) The income of the trust for fiduciary accounting purposes is $92,400, computed as follows:

Rents		$25,000
Dividends		50,000
Tax-exempt interest		25,000
Total		100,000
Deductions:		
Expenses directly attributable to rental income	$5,000	
Trustee's commissions allocable to income account	2,600	
		7,600
Income computed under section 643(b)		92,400

One-half ($46,200) of the income of $92,400 is currently distributable to each beneficiary.

(c) The distributable net income of the trust computed under section 643(a) is $91,100, determined as follows (cents are disregarded in the computation):

Rents		$25,000
Dividends		50,000
Tax-exempt interest	$25,000	
Less: Expenses allocable thereto ($25,000/100,000×$3,900)	975	
		24,025
Total		99,025
Deductions:		
Expenses directly attributable to rental income	$5,000	
Trustee's commissions ($3,900 less $975 allocable to tax-exempt interest)	2,925	
		7,925
Distributable net income		91,100

In computing the distributable net income of $91,100, the taxable income of the trust was computed with the following modifications: No deductions were allowed for distributions to the beneficiaries and for personal exemption of the trust (section 643(a) (1) and (2)); capital gains were excluded and no deduction under section 1202 (relating to the 50 percent deduction for long-term capital gains) was taken into account (section 643(a)(3)); the tax-exempt interest (as adjusted for expenses) and the dividend exclusion of $50 were included

(section 643(a) (5) and (7)). Since all of the income of the trust is required to be currently distributed, no deduction is allowable for depreciation in the absence of specific provisions in the governing instrument providing for the keeping of the trust corpus intact. See section 167(g) and the regulations thereunder.

(d) The deduction allowable to the trust under section 651(a) for distributions to the beneficiaries is $67,025, computed as follows:

Distributable net income computed under section 643(a) (see paragraph (c))		$91,100
Less:		
Tax-exempt interest as adjusted	$24,025	
Dividend exclusion	50	
		$24,075
Distributable net income as determined under section 651(b)		67,025

Since the amount of the income ($92,400) required to be distributed currently by the trust exceeds the distributable net income ($67,025) as computed under section 651(b), the deduction allowable under section 651(a) is limited to the distributable net income of $67,025.

(e) The taxable income of the trust is $7,200 computed as follows:

Rents		$25,000
Dividends ($50,000 less $50 exclusion)		49,950
Long-term capital gains		15,000
Gross income		89,950
Deductions:		
Rental expenses	$5,000	
Trustee's commissions	2,925	
Capital gain deduction	7,500	
Distributions to beneficiaries	67,025	
Personal exemption	300	
		82,750
Taxable income		7,200

The trust is not allowed a deduction for the portion ($975) of the trustee's commissions allocable to tax-exempt interest in computing its taxable income.

* * * * *

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